Some LECs appeal to contestability theory to argue that the market is competitive.[253] As MCI pointed out in its comments, the significant and sizeable barriers to entry in the market make that theory irrelevant.[254]

The only reasonable conclusion to be derived from this set of facts is that today's access market is not competitive. Nor will it become so soon. For purposes of designing new price cap rules that will treat access customers fairly, the Commission must assume that the LECs have, and will retain, substantial market power.[255]

Transition Issue 1b: The Criteria that should be used for determining when reduced or streamlined regulation for price cap LECs should take effect.

The Commission proposed 8 factors for consideration in establishing whether competition exists. As MCI indicated in its comments, a multi-factor

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pp. 70-71 (footnote omitted).

[253] See, e.g., NYNEX Comments, p. 22,; and US WEST Comments, p. 82.

[254] MCI Comments, p. 66.

[255] At the same time that Pacific Telesis tries to convince the Commission that competition in the $100 billion local market is vigorous because the CAPs have captured a few hundred million dollars in revenue, it argues that the interexchange market, with hundreds entrants and dramatically falling prices is not competitive. See Comments, pp. 87-96. This analysis from the Alice in Wonderland school of economics does not help the Commission. In the course of its diatribe against the IXCs, Pacific cites the discredited NERA study that allegedly shows that IXC price reductions are due entirely to the access reductions that the Commission has forced the LECs to make. Robert Hall shows that long distance prices net of access fell by 66 percent between 1985 and 1992, after adjustment for inflation. See Long Distance: Public Benefits from Increased Competition, October 1993, p. 10.

approach should be used to evaluate whether effective competition exists on a service-specific and geographic-specific basis. MCI provided comments on each of the individual factors proposed by the Commission, but cautioned that the Commission should err on the side of keeping regulatory safeguards in place in light of the incentives and abilities LECs have to harm competition.[256]

Several LECs propose "addressability" as a factor that the Commission should use when evaluating competition. According to U.S. West, "for a customer's demand to be addressable, an alternative provider must already have facilities near enough to the customer's location so that the provider can readily extend service to that customer on request."[257] On its face, addressability is a factor that the Commission should consider. But the Commission should recognize that even by this LEC-supported measure, there is little competition in the market place today.

As MCI noted supra, CAP networks are limited to serving several hundred buildings in the central business districts of the larger cities. Therefore, most customers, most buildings, and most of the territory in the country are not addressable.

The LECs argue that since CAPs have built fiber rings in these central business districts, all of the access revenue generated by customers located in the central business districts is addressable. For example, Robert Harris, on

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[256] MCI Comments, p. 67.

[257] US WEST Comments, p. 82.

behalf of USTA believes that "for buildings currently passed by their network, all the CAP need do is run an access line into the building. . . . For buildings close to but not passed by the CAP network, the CAP need only extend its network to pass those customers."[258] This statement betrays a fundamental lack of understanding of the reality of the CAP business.

First, even for buildings located on a CAP fiber ring, running an access line into the building can be difficult. The line must be extended from the ring into the building, which can be expensive. Egress from the CAP right-of-way might involve significant engineering expense. Building owners have been known to charge exorbitant access fees, or at times, flatly deny access. Even in cases where a CAP has a customer in a particular building, extending service to a second customer can be difficult. Depending on the customer's location within the building, separate riser facilities may be required.

Second, only the LECs have ubiquitous rights-of-way. Therefore, extending CAP rings can be difficult. Rights-of-way must be procured and construction must be undertaken, and both can be quite expensive. Third, there are substantial fixed costs associated with serving individual customers. The electronics to serve the customer must be purchased. In addition, building owners often charge rent for space used to house the customer equipment.

[258]USTA Comments, Attachment 2, p. B-6.

Given all of these barriers to CAP expansion, the LECs vastly overestimate revenues "at risk" when they provide calculations showing the geographic density of traffic.

Some LECs argue that capacity is a reasonable measure of CAP presence in a market.[259] CAPs put substantial fiber capacity in place when they construct their rings. But this raw capacity vastly overstates their market presence. To use the capacity, CAPs must have customers. Their existing customer base is simply too small to absorb much of the capacity. The capacity is worthless as a competitive alternative, however, if customers are located in a city where CAPs do not provide service, are not located near a ring in cities where CAPs do provide service, are in a building that does not provide for CAP access, or are too small to justify the fixed expenses of connecting to the ring. Thus, the fact that CAPs have sufficient raw capacity to serve a much larger portion of the market than they do is, by itself, a meaningless statistic.

Transition Issue 1c: In what circumstances a LEC will no longer control essential "bottleneck" facilities for some or all of its services. How the Commission will be able to identify these circumstances in practice.

MCI's comments suggested that the Commission focus on ways to promote additional local competition so that the criteria by which competition can be evaluated (discussed in Transition Issue 1b, supra) can be usefully applied.

[259] See, e.g., BellSouth Comments, p. 81, citing John Haring and Jeffrey Rohlfs, "Comments on Transition Issues."

In particular, MCI suggested the Commission should be concerned with: unbundling, co-carrier status for alternate providers, appropriate costing and pricing rules, a competitively neutral and cost-based universal service program, and appropriate service by service relaxation of price caps. Quibbling over the terms by which the LECs' undeniable market power should be described is not a useful exercise.

Predictably, some of the LECs argue that the bottleneck no longer exists. For example, Ameritech argues that "unbundling loops from switches and the integration of competitors' end-offices into the public switched network eliminates any vestiges of the bottleneck."[260] One simple fact rebuts this assertion: MCI knows of no consumer anywhere in the country whose demand for local exchange telephone service can be satisfied without reliance on LEC facilities. The essence of local exchange telephone service is the ability for any customer of the service to communicate with any other customer.

Even for customers who may someday be able to enter the local exchange network over facilities provided by a non-traditional carrier, interconnection with the LEC at some point will be essential. Unbundling will promote access to the bottleneck and allow competition to develop more readily, but it does not alter the fact of the bottleneck.

US WEST argues that there are several standards that must be met before a facility can be treated as essential:

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[260] Ameritech Comments, p. 31.

> a facility is vital to competitive survival; no alternatives to the facility currently exist; a facility cannot be practically or reasonably be duplicated; LEC control of the facility must allow it to eliminate, not merely impede, competition; and LEC access to or use of the facility would not be impaired by a competitor's use of the facility.[261]

When one recognizes that the bottleneck facility is the local exchange, including the totality of the customer links and switches connecting them, it becomes clear that, even by US WEST's standards, the LECs do indeed control essential facilities.

Transition Issue 1d: The ability of CAPs and others to compete with the LECs.

In response to this issue, many of the LECs simply catalogue all of the various technologies that may or may not someday play a role in local exchange competition.[262] The key point to keep in mind is that, as MCI discussed supra, today's reality is that there is little existing competition for the essential access facilities that are regulated under price caps. In the process of describing the realities of the CAP marketplace, MCI explained the limitations on current competitors. As MCI discussed in Transition Issue 1c, supra, there are known steps the Commission can and should take to encourage competition.

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[261] US WEST Comments, p. 86.

[262] See BellSouth Comments, pp. 83-91.

Transition Issue 1e: The impact price cap LEC entry into related industries and LEC entry into interLATA marketplaces should have on the LEC price cap plan.

Several LECs argue that LEC entry into new markets should have no impact on price cap regulation.[263] MCI pointed out in its comments that a correctly calibrated price cap plan can limit the ability of LECs to raise monopoly rates in order to subsidize competitive ventures. While properly calibrated price caps are a necessary safeguard, they are by no means sufficient. MCI encourages the Commission to take the pro-competitive steps discussed in its comments.[264]

It is also important that the Commission develop rules to ensure that LEC entry into Video Dialtone does not result in cross-subsidy. Existing Commission Rules are not adequate to prevent subsidization of Video Dialtone service from access revenues.[265]

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[263] See Ameritech Comments, p. 33.

[264] MCI Comments, pp. 64-81.

[265] See MCI Comments, Amendment to Bell Atlantic ONA Plan, Video Dialtone Service, CC Docket No. 82-2, Phase I, filed May 12, 1994.

TRANSITION ISSUE 2: TRANSITION STAGES

Regulatory methods for reducing price cap regulation or streamlined regulation that should be adopted for LEC Services as those services become subject to greater competition.

Most of the LECs give short shrift to this issue since they are asking for changes in price cap regulation that would amount to immediate drastic relief from necessary regulatory safeguards. As noted in its comments, MCI is skeptical that competitive developments will ever allow across-the-board streamlining of all LEC services.[266] Whether or not MCI is correct about the future development of competition, one thing is clear: the necessary changes to the existing price cap plan can be made without regard to the hypothetical state of competition some time in the future.

In any event, the classic response to competition is to reduce prices. The primary focus of the LECs is to ask for changes that will allow them to charge higher prices. For example, the LECs are asking for a reduced productivity factor, which will allow them to extract more revenues from their customers. The failure of the LECs to propose rates under the existing price cap regime that are significantly below the caps also illustrates why streamlining is not appropriate at this time.

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[266] MCI Comments, pp. 65-68.

TRANSITION ISSUE 3: REVISIONS TO BASKETS

Whether and how the Commission should schedule revisions in the composition of price cap baskets as local exchange access competition develops.

See supra MCI response to Baseline Issue 3.

TRANSITION ISSUE 4: SERVICE QUALITY, NETWORK RELIABILITY, AND INFRASTRUCTURE

Whether and how the Commission should revise its monitoring of LEC service quality, network reliability, and infrastructure as part of any transition plan.

See supra MCI response to Baseline Issue 7.

TRANSITION ISSUE 5: FREQUENCY OF REVIEW UNDER PRICE CAP REGULATION

When the Commission should next review the price cap LECs' performance. The frequency with which the Commission should conduct subsequent reviews.

In its initial comments, MCI recommended that the Commission "re-evaluate the LEC price cap plan starting after three years from the completion of this review."[267] MCI anticipates that development of effective competition may eventually require fundamental changes to the price cap plan, and that the Commission should schedule periodic reviews during the period of transition to a more competitive market in order to ensure that the current state of competition is correctly reflected in the plan's design.

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[267] Id. at 81.

Not surprisingly, the LECs who filed comments either recommend a much longer period before the next review, or no scheduled review at all. Southwestern Bell, BellSouth, and US WEST for example, urge the Commission to not plan the next review for eight to ten years.[268] Both Ameritech and USTA claim that if the Commission adopts either of their proposals, that there is no need to even schedule a regular review of the plan.[269] Any suggestion that a frequent subsequent review is unnecessary should be dismissed as premature since the price cap plan formula has not been reliably validated as capable of achieving the Commission's goals, and the telecommunications market is in a state of transition that demands frequent review of the plan.

Whether "efficiency incentives are reduced by the prospect of rate reductions when the price cap plan is renegotiated"[270] must be balanced against the risk of failing to correctly set and monitor the price cap formula. MCI anticipates that the Commission will recalibrate the price cap formula as a result of information gleaned in the instant price cap review that indicates that the formula was not correctly set initially. Modifying the formula now (or in the future, if necessary), for example, to accurately reflect the LECs' historical productivity

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[268] See, e.g., BellSouth Comments, p. 97 (presaging tradeoff between magnitude of LEC efficiency gains versus frequency of price cap review); Southwestern Bell Comments, p. 64 (suggesting reduced efficiency incentives associated with shorter review plans); and US WEST Comments, p. 90 (assuming stable price cap plan between reviews).

[269] See Ameritech Comments, p. 34; and USTA Comments, pp. 94-95.

[270] Southwestern Bell Comments, p. 63, n.99 (citing SPR, p. 19).

and the cost of capital, should have no bearing on the LECs' incentives. Indeed, to claim that it does is to suggest that the LECs are motivated by conditions beyond their command (and deserving of windfall profits over which they had no control) -- a declaration that mocks the efficiency incentives actually incorporated in the plan. Simply put, until the Commission is confident that it has chosen the correct productivity measure,[271] and it ensures that appropriate safeguards are established and maintained to guarantee a proper transition to a competitive market, failure to periodically review the price cap plan operation would represent abdication of its statutory duties.

TRANSITION ISSUE 6: OTHER TRANSITION ISSUES

Other issues that may be relevant to developing an effective transition plan.

MCI has no comments to make on this issue at this time.

CONCLUSION

For the foregoing reasons, MCI urges the Commission to endorse goals that facilitate, rather quash the development of a competitive telecommunications market; adopt a 5.9 percent productivity offset; require a one-time adjustment to the LECs' price cap indexes; retain and recalibrate the sharing mechanism to

[271] Ameritech suggests that there is "no need to change the productivity offset." Also, it envisions that the only changes to the price cap plan will be "increasing flexibility." Ameritech Comments, p. 45. Any recommendation made in light of these faulty assumptions should be summarily rejected.

reflect the current cost of capital; incorporate the per-line formula for capping the Carrier Common Line basket; endorse MCI's recommended modifications to the exogenous cost criteria; and establish a price cap adjustment mechanism to ensure IXCs do not underwrite price cap LECs' divestiture of high-cost properties.

Respectfully submitted,
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June 29, 1994

ATTACHMENT A

MCI's COMPUTATION OF INTERSTATE ACCESS TOTAL FACTOR PRODUCTIVITY

USTA's Christensen Study computes total output indexes for all LEC services, including interstate access services, local service, intrastate access, long distance, and other services. It derives the total output index for all LEC services by taking a weighted average of these individual indexes, using relative revenue for the services as the weights. This Attachment explains MCI's development of an output index from the data used in the Christensen study. MCI contends that it is only the interstate experience which should be evaluated in considering revision to the Commission's price cap plan.

The attached chart displays the output indexes for interstate end user common line ("IS EUCL"), interstate switched access ("IS Sw"), and interstate special access ("IS SpAc") for 1984 through 1992, as reported by Christensen. It also reports the revenue weights used in the Christensen Study for these three categories, computed as a percentage of total LEC revenue.

From these revenue weights, the relative revenue weights for interstate access are derived. In each year, the interstate access revenue weight for each category is that category's total revenue weight for that year divided by the sum of the total revenue weights for all three interstate access categories. For

example, if each of the three categories were 10 percent of total interstate revenue, then each would be 33.33 percent of interstate access revenue.

The total interstate access revenue weights are then multiplied by the corresponding output index, and the results are summed. This gives the total interstate access output index. Growth rates of that index reported on the attached chart for each year are the simple growth rate of the index over the previous year. The average growth, 1984 to 1992, reported on the chart is the 1992 index value divided by the 1982 index value, raised to the 1/8th power, minus 1. This 8 year average growth rate is 6.4 percent.

COMPUTATION OF LEC INTERSTATE ACCESS PRODUCTIVITY

	Output Indexes			Revenue Weights: Percentage of Total			Revenue Weights: Percentage of Total Access			Output Index – Total Access	Growth, Total Access Output
	IS EUCL	IS Sw	IS SpAc	IS EUCL	IS Sw	IS SpAc	IS EUCL	IS Sw	IS SpAc		
1984	1.000	1.000	1.000	0.009	0.191	0.032	0.039	0.823	0.138	1.000	na
1985	1.030	1.068	1.027	0.024	0.181	0.030	0.102	0.770	0.128	1.059	5.9%
1986	1.056	1.145	1.377	0.037	0.167	0.038	0.153	0.690	0.157	1.168	10.3%
1987	1.088	1.268	1.466	0.047	0.153	0.039	0.197	0.640	0.163	1.265	8.3%
1988	1.109	1.420	1.465	0.053	0.149	0.036	0.223	0.626	0.151	1.358	7.3%
1989	1.143	1.592	1.418	0.064	0.139	0.032	0.272	0.591	0.136	1.446	6.5%
1990	1.173	1.705	1.410	0.067	0.129	0.031	0.295	0.568	0.137	1.508	4.3%
1991	1.212	1.804	1.320	0.068	0.126	0.029	0.305	0.565	0.130	1.561	3.5%
1992	1.231	1.914	1.401	0.069	0.126	0.029	0.308	0.563	0.129	1.637	4.9%
									Average Growth, 1984 to 1992		6.4%

ATTACHMENT B

MCI's COMPUTATION OF THE DIFFERENCE BETWEEN A PER-MINUTE AND A BALANCED 50/50 UNIFIED PRODUCTIVITY FACTOR

In the Supplemental Notice, the Commission reported a unitary productivity factor of 2.88 percent for the originally proposed 50/50 formula, which is a weighted average of separate per-minute traffic sensitive (1.42 percent) and 50/50 common line (4.12 percent) productivity factors.[272] The weight for the traffic sensitive index is 0.54, and the weight for the 50/50 common line index is 0.46 percent (i.e., (0.54*1.42 percent) + (0.46*4.12 percent) = 2.88 percent).

The Commission also reported a separate per-minute common line productivity factor of 7.18 percent.[273] Using the same relative weights of traffic sensitive and common line as used to develop the originally proposed 50/50 unitary productivity formula supra, the unitary productivity factor under the per-minute common line formula is 4.07 percent (i.e., (0.54*1.42 percent)+(0.46*7.18 percent)), or about 1.2 percent higher than the productivity factor in the originally proposed 50/50 formula. Thus, the difference in the productivity factor needed in the per-minute formula and the originally proposed 50/50 formula is the difference between 4.07 percent and 2.88 percent, or almost 1.2 percent.

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[272] See Supplemental Notice of Proposed Rulemaking, CC Docket No. 87-313, 5 FCC Rcd at 2176, 2326 (1990)("Supplemental Notice").

[273] Id.

In the LEC Price Cap Order, the Commission reported differences in productivity factors for the originally proposed and balanced 50/50 formulas of about 0.7 percent.[274] Thus, the difference between the productivity factors in the balanced 50/50 formula and the per-minute formula is 1.9 percent.

[274] See LEC Price Cap Order, 5 FCC Rcd at 2176, 6798 (1990).

STATEMENT OF VERIFICATION

I have read the foregoing and, to the best of my knowledge, information, and belief, there is good ground to support it, and it is not interposed for delay. I verify under penalty of perjury that the foregoing is true and correct. Executed on June 29, 1994.

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CERTIFICATE OF SERVICE

I, Gwen Montalvo, do hereby certify that copies of the foregoing Price Cap Performance were sent first class mail, postage prepaid, to the following on the 29th day of June 1994.

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